VIEWPOINTS

4TH QUARTER 2014 | ADVISORY NEWSLETTER

2014 - 20TH ANNIVERSARY YEAR

MARKET COMMENTARY **FREDRIC W. WILLIAMS**

Running Into The Wall of Worry…

> *"All past market crashes are viewed as opportunities, but all future market crashes are viewed as risks."*
>
> - *Morgan Housel, WSJ 12/8/14*

The Year of the Horse (2014) closed with a whimper, as the domestic equity markets sold off from record highs hit on December 26th, while the new year ushered in continued fear and volatility as the ghosts of quarters past revisited investors who were already squeamish given the fear of the unintended (and potentially unknown) consequences from the free fall in energy prices. Although initially positive about the impact of the drop in oil on the consumer's costs at the fuel pump, concerns lingered about what might happen to the domestic energy industry and the spark it has provided to our GDP as we moved to our position as the globe's new energy production leader. (See Jay's commentary below) This perceived disparity perpetuated Q3's volatility into the year's closing quarter with the VIX spiking above 25 in mid-October and then again in mid-December, as investors attempted to digest these various economic and geo-political cross currents.

Unfortunately, the fear brought on by this volatility can cause unsettled investors to make emotional decisions outside of the context and structure of their longer term, and more prudent, comprehensive wealth management plans. As Mr. Housel's article (quoted above) points out, successful investing is overwhelmingly a game of psychology, where battling the demons of short term tunnel vision tend to be the root of many investment problems. He continues that markets reward patience more than most other skill, so focusing on the next five years, rather than the next five months, will prevent one from succumbing to the emotional urge to buy high and sell low.

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This phenomenon (retail investors as contrarian indicators) has been talked about in the past, but only recently have researchers in behavioral finance attempted to quantify the actual cost, and impact, that this non-disciplined decision making process has on both portfolio returns as well as longer term wealth accumulation.

The Fed conducts a "Survey of Consumer Finances" every three years, and their data for the years 2007-2010 as well as 2010-2013 shows that among the bottom 90% of households by wealth, 4.4% (or 5.4 million families) were selling shares, even as the market rebounded.

A University of Michigan study (Chen & Stafford, 2014) cross referenced this data with that from the Panel Study of Income Dynamics to suggest that not only were the net buyers from the top 10% of households, but that this group tended to share higher education and stronger portfolios as well.

> *"One unfortunate effect of recessions and stock-market declines is they often induce people to exit the market at exactly the wrong time. In retrospect, anyway, the right thing to do would have been to buy more equities at the trough, not to sell equities at the trough"*
>
> - *Dean Maki – Barclays Economist*

A simple comparison makes these somewhat ethereal concepts much more concrete and reality based:

> *"Imagine two well-off households, each with $100,000 in the stock market in 2007. A family that sold in 2009 after losing half its portfolio's value may now have about $50,000 in a savings account. A family that held on would now have about $130,000 in stocks. The inequality (with regard to wealth disparity in the U.S.) has yawned merely because of the investing decisions. In the long run, those savings accounts have a vanishing small chance of outperforming stocks."* - *Josh Zumbrun – WSJ*

Although perhaps a tad extreme from a time horizon standpoint, Jeremy Siegel, a Wharton School economist quoted in this space in the past, calculates that over the last two centuries stocks have returned an average of 6.7%, outperforming bonds, gold and the dollar. Given the inherent volatility of single asset class exposure to a portfolio's interim valuations, "prudent man" guidance suggests that diversification be the focus of any reasonable investment policy such that the lack of correlation between these varying asset classes can smooth out overall pricing variations.

To achieve this investing nirvana, however, the prudent investor needs to come to grips with, and accept as optimal, the fact that over time some of one's investments will perform worse than others at particular points in time. Should all the holdings in a portfolio be blissfully marching upward in unison, it might be a good idea to look around and see if you're surrounded by a sea of lemmings heading toward an unexpected free fall.

Although 2014 was one of those occasional aberrant years that did not reward asset class diversification (see Jason's overview below) we continue to believe that the low valuation/high dividend focus of our research discipline will provide positive reduced-volatility risk adjusted returns over the longer term.

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Return of the Rollercoaster… **Jason Foster**

The 4th quarter of 2014 was action-packed with multiple story lines impacting markets at home and abroad. Equities experienced renewed volatility, divergence among asset classes continued, US stocks finished near record highs and to top it off; the relentless fall in crude oil left the price per barrel down 46% for the year.

Volatility arrived in October as the S&P 500 slid just shy of 10% from its highs in September, wiping away nearly all gains for the year. But as investors became less concerned over the Fed hiking rates and fears of an Ebola pandemic waned, the markets recouped all losses finishing positive for the month. From there, with a shallow dip in between, the ascent continued with the S&P 500 adding 4.9% for the quarter and ending the year with a 13.7% total return.

U.S. small cap stocks that had struggled all year rallied 9.7% for the quarter allowing the asset class to finish 2014 with a positive 4.9% return, but well short of their large cap brethren. Domestic commercial real estate or REITs, which disappointed investors in 2013, led the way with a 28% return for the year. While US markets flexed their muscles, fears of recession pushed overseas markets downward. International equities, as measured by the EAFE index, slipped -3.5% for the quarter, ending 2014 with a negative return of -4.5%. What little gains remained in Emerging Markets faded away as the commodity and energy sensitive benchmark closed out the year at -1.8%, the second consecutive annual loss for the asset class.

Fixed income markets experienced performance divergence as well. The US dollar's persistent strengthening vs. foreign currencies, coupled with rates trending lower, contributed to the lift in the US Barclays aggregate broad benchmark. Despite the nearly universal consensus among economists early in the year for interest rates to rise and thus heightening the odds for damage in bonds, the index posted a 5.97% return for the year as rates fell. As for the High Yield market, with the energy sector being the largest component, it dropped a percent for the quarter, but managed to eke out an in-the-black return of 2.45% for the year. On the other hand, foreign bond returns were generally much lower, especially for those countries with currency devaluation strategies. For example, aggregate Japanese bonds experienced losses of -8.35%, while European corporate debt fell -4.82%. Looking at year-end yields below, as investors we wonder what signal the fixed income markets are sending:

Yields as of 12/31/1014	
10-Year US Treasury	2.17%
10-Year German Bund	0.58%
10-Year Japanese Gov't Bond	0.36%

Similarly, economic news mirrored market movements as it was more US vs. them. Solid data on American business and the economy boosted confidence in the now 6th year of recovery from the Great Recession. Small business lending reached levels not seen since prior to the financial crisis. Consumer balance sheets resumed strengthening as assets

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increased and household debt service ratios declined. The unemployment rate fell to 5.6%, while inflation remained in-check, putting less pressure on the Fed to raise rates. And the final exclamation point for the year came in December when an unexpected upward revision in GDP was announced revealing a 5% growth rate in the 3rd quarter. Meanwhile in Europe recession fears mounted adding speculation that the ECB would need to act soon with more monetary stimulus. Japan's aggressive monetary policy alone proved it was not enough, at least not yet, as the country announced it had officially entered into a recession with its second consecutive decline in GDP. Then there was Russia. In an attempt to protect the Ruble, Russia hiked rates by 650 basis points bringing the country's short-term rates to 17%, a stark contrast to rates across the developed world.

As we look across the investment landscape entering into 2015 the maturing S&P trades on par with its 20-year average PE, with a backdrop of encouraging economic momentum, extremely low interest rates and an accommodating Federal Reserve. While developed equity markets outside the US trade near average levels, but with mixed economic news and less uniform central bank policy. Layered on top is the staggering drop in energy prices with consequences, good and bad, for all economies across the globe. We expect the year to be more challenging than in the recent past and look forward to navigating the markets in 2015.

Index Returns			
Equities	*Percentage Change for the 4th Quarter*	*Percentage Change for the Year*	*Annualized 10-Year Returns*
S&P 500	**4.93%**	13.69%	7.67%
DJ UBS Commodity Index	**-12.10%**	-17.01%	-1.86%
MSCI EAFE	**-3.57%**	-4.90%	4.43%
MSCI EM	**-4.51%**	-2.19%	8.43%
NAREIT Equity REIT Index	**12.9%**	28.0%	8.3%
Fixed Income			
Barclays Aggregate	**1.79%**	5.97%	4.71%
Barclays U.S. Treasuries	**1.93%**	5.05%	4.38%

Oil Slides: Is it Simply Supply & Demand? — *Jay Flower*

Crude oil prices started to slide mid-year and eventually dropped to levels we haven't seen since the Great Recession as the year came to a close. As of this writing, Light Sweet Crude Oil was trading at $49.86/barrel and just six months ago that same barrel was changing hands at about $105/barrel (see chart below). There have been plenty of expert theories and predictions in recent weeks about the cause and ultimate effect of such a dramatic drop in oil prices ranging from basic supply and demand dynamics to more sensational price manipulation schemes and geopolitical wrangling. We feel it is primarily related to the former although it is clear that continued low oil prices favor some countries and could bankrupt others.

US oil production has almost doubled in the last six years due primarily to the boom in shale oil. There are currently many more shale projects planned to come on-line and even be profitable at these levels. Our increased production (supply) and the continued economic weakness in Europe, China and most Emerging Markets (demand) along with the recent strengthening of the US Dollar versus other major currencies like the Euro, Yen and Yuan *should* lead to lower oil prices. However, the rate and depth of the decline can't be fully explained by simple supply and demand theory.

A major catalyst for the continued decline in oil prices was the decision in late November by the Organization of the Petroleum Exporting Countries (OPEC) to not reduce its current production rate. Several countries (Saudi Arabia, UAE, Kuwait and Qatar) in the Gulf Cooperation Council (GCC) are OPEC members with spare capacity and the lowest production costs and we feel it is reasonable to assume there are a number of factors that led them to enthusiastically support keeping production levels steady. First, geopolitical motivations. Currently relations are strained between Saudi Arabia and Iran, and between Iraq and Russia. Keeping prices low or allowing them to go even lower only causes more economic pain to all those countries. Second, US Shale. Saudi Arabia wants to trim the small to mid-size U.S. shale producers and simply *slow* the growth in U.S. production in order to maintain its market share. The majority of the growth in global production has come from the U.S. in the last 5-6 years. Third, stop new production projects. Projects with high fixed-costs like oil sands and ultra-deepwater rigs can only be considered with prices around \$90-\$95. Now that prices are so low many of these projects will be delayed if not cancelled.

Low oil prices were initially touted as being stimulative to the US economy and thus the markets due to the benefits to the consumer via increased savings at the pump and home heating oil. However, the dramatic decline in recent weeks has led to increased uncertainty about where the bottom is and what the short, mid and long-term implications might be. As we know, uncertainty typically results in indiscriminate selling and this has certainly added to the recent volatility. The energy sector as a whole has been hit hard but some of the more risk/reward subsectors like exploration, equipment and services and drilling are down two and almost three times more than the sector (see chart below).

NED DAVIS RESEARCH GROUP — U.S. Strategy: Benchmarks | JANUARY 2, 2015

Q4 AND 2014 SECTORS AND INDUSTRIES PERFORMANCE

Sectors and Industries	Q4 Performance	2014 Performance
S&P 500 Energy Sector	-11.26	-9.99
Energy Sector	-11.96	-10.26
Energy Industry Group	-11.96	-10.26
Oil, Gas & Consumable Fuels Industry	-10.33	-9.30
Oil & Gas Refining & Marketing Sub-Industry	-1.80	-3.80
Integrated Oil & Gas Sub-Industry	-4.47	-9.11
Oil & Gas Storage & Transportation Sub-Industry	-8.51	15.03
Coal & Consumable Fuels Sub-Industry	-18.16	-32.42
Oil & Gas Exploration & Production Sub-Industry	-20.86	-15.73
Energy Equipment & Services Industry	-24.05	-18.01
Oil & Gas Equipment & Services Sub-Industry	-23.43	-16.14
Oil & Gas Drilling Sub-Industry	-28.57	-30.27
S&P 500 Index (Equal Weighted)	5.59	12.35

Sources: S&P Index Alert, NDR Multi-Cap Institutional (Universe), S&P Capital IQ and MSCI, Inc. (GICS). Price only. N/A's for new sub-industries with insufficient history.

Ned Davis Research Group — T_BF15_01.7

History has taught us that big price-movements like this recent drop in oil most likely mean continued volatility with big swings on a daily basis for irrational reasons. We also have learned that these unpredictable times often present opportunities that we may not realize for months or years later and trying to time the bottom or top is impossible. We continue to believe that investing in high-quality and diversified energy companies with strong earnings represent an integral component to a well-built portfolio. We currently favor the larger and more defensive companies like refiners, integrated oil companies and the MLP sector as a whole, although, the previously mentioned 'opportunities' most likely will be found in the subsectors that have been hit the hardest like the drillers. Only time will tell.

FIDUCIARY CORNER — STEPHEN L. EDDY

Mutual Fund Industry Update

At last count there were 29,877 open-end mutual funds in the US market. Even with that potentially mind-numbing number of funds, the mutual fund industry typically plods through various market-related cycles without creating too much fanfare. However, in the past several months we have been treated to two pieces of very significant news.

First, in September 2014 legendary bond investor and PIMCO chief investment officer Bill Gross abruptly left PIMCO (the firm he founded) to go to Janus, a comparably minor player in the fixed income world. This was major news. Bill Gross is one of the few people which when he speaks, the industry listens. He can move markets with a comment. Much has been written as to why he left – conflicts with management, burn-out, etc. – but the more pressing issue for fiduciary investment advisors is what Gross is leaving behind, particularly for his flagship Total Return bond fund which is a component in many retirement plan lineups.

Apparently he leaves behind a stable of very highly qualified managers for his flagship fund who have outperformed their peers since he left. In spite of this fact, the fund saw outflows of $103 billion in 2014 and now has "only" $143 billion in assets. However, after exhaustive analysis Morningstar says that "*as of early 2015, PIMCO and many if not virtually all of its* *funds remained very well-situated to weather a period of moderate outflows, considering the liquidity of a large percentage of net assets.*" Our view at Old Port Advisors is that we have placed PIMCO's funds on our "monitor" list and will take appropriate action as needed if the metrics change, but we are not going to overreact.

The second piece of news is that in 2014, Vanguard, the biggest provider of low cost index tracking products, set an all-time record for inflows for the mutual fund industry with $216 billion in new assets. This moves their assets under management above the $3 trillion mark which makes them the country's largest fund family. There are several reasons for this continued growth:

1. There are oft-cited studies that indicate on average 70% of managers don't beat their corresponding index in any given year (Vanguard agrees).
2. Brokers are including more low-cost Vanguard funds in retirement plans because it makes their all-in fee numbers look better (it does, and deflects attention from <u>their</u> fee).
3. TPA platforms like Paychex and others try to compete with Fidelity, TIAA-CREF, Empower and American Funds by offering "efficiency" lineups of all Vanguard funds (it makes their cost comparisons look good, but not well thought out).
4. In early 2014, Vanguard began a partnership with Ascensus to provide recordkeeping services for a low-cost Vanguard-based retirement plan product (true to Vanguard's low-cost mantra, the fees are all participant-based - costs don't rise as assets grow)
5. Warren Buffet has famously bet a hedge fund manager that the S&P index will outperform the manager's hedge fund over 5 years (the Oracle is handily winning this bet), and he also recently disclosed his estate's investment directions for his non-Berkshire investments: 90% Vanguard S&P 500 index fund, 10% in US Treasuries.

Whether from a publicity, common-sense or competitive standpoint, all of the above reasons continue to drive assets to Vanguard. At Old Port Advisors, we like the idea of utilizing Vanguard funds in retirement plan lineups to give passive/index investors an alternative. After that building block base of funds, it is our job to find the 10% of managers who consistently outperform their peers.

PLANNING CONCEPTS

Financial Aid and the CSS profile — Tracy Rogers

As parents are now starting to fill out their FAFSA form (Free Application for Federal Student Aid), we thought it would be a good time to revisit the other common application profile, the CSS profile.

The College Scholarship Service (CSS) profile is an application used by some private colleges and universities, around 400+ at this point. It requires more information than needed for the FAFSA. In simplest terms the FAFSA is for applicants applying for Federal Financial Aid whereas the CSS Profile is for applicants applying for scholarships and programs at the individual schools. Because of this, the CSS questionnaire is much more in depth and takes into account more financial information than the FAFSA. There are 300 plus questions on the CSS compared to the 100 plus on the FAFSA. Some schools even have

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additional questions they want answered as part of the CSS. Some differences between FAFSA and CSS are:

- **Application cost:** The CSS Profile is $25 to submit to the first school and $16 thereafter
- **Dates:** FAFSA starts on January 1st of each year whereas the CSS Profile can start in October for early decision candidates. Each institution may dictate its own deadlines.
- **Income, Assets and Family:** Some things the CSS looks at that the FAFSA does not.
  - **Income**
    - Income of non-custodial parents (divorce)
    - Rental income
    - Business Income
    - Wages (not just AGI)
  - **Assets**
    - Home equity and farm equity
    - Student Trusts
    - Parent assets held in siblings names
    - Investment real estate value
    - Non-qualified annuities
    - Assets repositioned within two years
  - **Family**
    - Non-custodial parents including step-parents are included
    - Siblings(private tuition being paid for elementary/secondary schools)
    - Medical expenses

As you can, see the CSS Profile asks for much more detail regarding the applicant's financial situation than the FAFSA does and as a result, it gives the school's financial aid officers much more information on which to base their awards. The CSS profile offers prospective students a second way to apply for financial aid to attend college and in spite of the number of questions asked and detail requested it can often be a very beneficial exercise for the applicant, to the point where it may help determine which school is most affordable for them.

What Does An Executor Do? **Missy Lyon**

It is highly probable that at some point in your life, you will be called upon to serve as the "Executor" for someone's estate. An Executor's primary role is to put the deceased's personal and financial affairs in order – for the final time. Rather than struggling with an "Executor" or "Executrix" title, many states, including Maine, have adopted the gender-neutral title "Personal Representative" commonly referred to as "PR."

This is typically a job we fall in to, not something we raise our hand and volunteer to do. Unfortunately, many families don't communicate important decisions to the PR and heirs ahead of time, so finding out and then learning the job duties often comes at an emotionally difficult time. Frequently the PR of an estate is the surviving spouse, a trusted friend or relative, and in some instances the family's attorney. When parents are selecting amongst children to fulfill the PR role, the most common methods include choosing the oldest child, choosing the closest child geographically, or choosing either all or multiple children. Choosing all children or more than one can further complicate and prolong the process, especially if one of the co-PRs lives out-of-town. Selecting one child, then naming the others as alternates, and letting everyone know in advance will provide for a better outcome and minimize hurt feelings.

PRs have a set of specific responsibilities and a timetable in which to complete them. The most common tasks are highlighted here. Early in the process, you will need to obtain an original death certificate. Funeral homes often provide relatives with abstracts of the death certificate that appear official in every way, however, are incomplete. You will need a complete original death certificate with the raised seal from the Probate Court clearly visible to process any legal or financial transactions on behalf of the decedent. Additionally, you will need to appear before the Probate Court with proper personal identification and both the original death certificate and the decedent's complete Last Will and Testament. Those two legal documents allow the Probate Judge to appoint you as "Personal Representative" of the estate.

Along with instructions for memorial services and disposition of the decedent's body, the will should itemize all known assets and instruct you on the disposition of property - vehicles, real estate, bank and brokerage accounts, collectible items or antiques and anything with sentimental value designated for specific people. The last part is often the most difficult and can include family photos, jewelry, and mementos. As an estate's PR, you need to be prepared to work through the family dynamics including any issues that may arise starting with the words, "Mom promised I could have …" Always bear in mind that your role is not to make sure there is an equitable division of property but to ensure that assets are distributed according to the decedent's wishes as stated in the will.

Remember that you don't have to go it alone when performing your PR duties. Most wills provide instructions and even encourage the PR to hire industry professionals when appropriate. Estate planning attorneys, CPAs, and investment advisors can assist you throughout the estate's lifecycle.

As the estate's Personal Representative, you are responsible for:

> Shepherding the estate through the probate process which can include defending it against contests.
>Collecting and organizing the assets of the deceased.
>Transferring legacies and gifs to the named beneficiaries and/or charitable organizations.
>Evaluating and paying any claims made against the estate – which typically consist of bills and taxes.
>Raising money to pay for the above-mentioned claims, which would involve selling assets including property and or securities owned by the estate.
>Preparing and filing the decedent's and the estate's last tax returns.

>Preparing and presenting a complete and final accounting of the estate to the probate court.

Hiring someone who specializes in the taxation of estates will be money well-spent. An estate typically owes two kinds of taxes – one is on the transfer of assets from the decedent to the beneficiaries and heirs (known as the estate tax), while the other is on the income generated by the assets owned by the estate itself (the income tax). The decedent and his/her estate are two separate taxable entities in the eyes of the IRS, so the PR will need to contact the IRS and obtain a different, distinct tax identification number prior to filing the estate's IRS 1041 form. (This is a simple process and can be done online).

Simple estates can take as little as six months to settle, while complicated estates owning multiple properties or a business, can take three or more years. PRs are allowed to charge for their services and most states set clear caps on what amount can be charged. When fulfilling the role for a friend or family member, fees are usually waived, although it is common practice for the estate to reimburse the PR for travel costs and necessary expenses required to fulfill the PR duties including the purchase of Court Appointments, Original Death Certificates, Notary fees, photocopying costs, etc.

Having vast legal and financial knowledge or experience is not necessary to successfully handle an estate. Being detail oriented, maintaining good records, and being vigilant about meeting deadlines are all skills that will be advantageous in addition to being a good listener and able to follow directions. Not being overwhelmed and intimidated by forms and procedures will also come in handy, since completing insurance forms, paying hospital bills, and interacting with banks and brokerages are common responsibilities of a Personal Representative.

If appointed PR for a friend or relative, remember that your OPA Portfolio Manager can guide you through the process and help you locate qualified tax and legal experts able to assist you.

OPA NEWS

Over the next several months we will be conducting a number of workshops and seminars – topics will range from Social Security maximization to college financing and retirement income generation. Contact our Portland office if you'd like to be included on our invitation list to these events.

Also, we will be launching our rebranded website in the near future – stay tuned for the new www.oldportadvisors.com!

Old Port Advisors was founded more than 20 years ago as Investment Management & Consulting Group (IMCG), with a vision to create a boutique independent investment management firm centered on the best interests of our clients. Our principles were simple and still ground us today: a values-driven, personalized, collaborative, and strategic approach to investing, wealth management, and fiduciary consulting. We changed our name to embark on the next 20 years, but our leadership and our calling remain. We're excited to build on our past experience and success to deliver on our promise of building a secure future for our clients.

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